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C O N F I D E N T I A L CARACAS 003575

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HQ USSOUTHCOM FOR POLAD
BUENOS AIRES FOR TREASURY (MHAARSAGER)

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TAGS: ECON EFIN PGOV VE
SUBJECT: CAUTION: THE ROAD IS WET - TREASURY REP GETS VIEWS OF VENEZUELAN ECONOMY

REF: CARACAS 3015

Classified By: ECONOMIC COUNSELOR RICHARD M. SANDERS FOR REASON 1.4 B AND D.

SUMMARY

¶1. (C) U.S. Treasury representative for South America Mathew Haarsager visited Caracas from November 2-5, and in a series of meetings with the Venezuelan private and public sectors was treated to a variety of perspectives. GOV officials asserted that, with the strike, presidential referendum, and regional elections behind them, high fiscal spending would continue to create sustained economic growth. Private sector representatives, while acknowledging that economic indicators are currently healthy, believe that short-term growth depends entirely on maintaining current oil prices, and long-term growth will require the unlikely occurrence of structural reforms. Multilateral lenders are trying to avoid any appearance of controversy, even if that means reducing their portfolios in Venezuela and not pressing the GOV to make needed reforms. END SUMMARY.

GOV - NO MORE TROUBLE

¶2. (C) GOV officials took the view that things are good, and are going to get better. Guillermo Ortega, General Coordinator for Public Policy at the Ministry of Finance, emphasized increased non-oil revenues and a drop in debt/GDP ratio. Luis Rafael Quiaro and William Grillet, respectively Vice President of Planning and General Manager of the state-owned Economic and Social Development Bank (BANDES) cited the rapid increase of their lending portfolio to small businesses in particular. Jose Rojas, Vice President of Finance of state oil corporation PDVSA, noted that it is currently contributing about half of 2004 GOV revenue (USD 15 billion) in taxes and royalties, and added that PDVSA was spending close to USD 5 billion more (NOTE: at least USD 2 billion is off-budget END NOTE) on social/infrastructure needs.

¶3. (C) The GOV officials made it clear that they saw the government as the engine of growth for the economy. Ortega said it was essential for expenditure to be sufficient to maintain growth, and that the GOV is still trying to bring spending up to its desired level. Quiaro stated that BANDES has a special emphasis on micro-credit, especially to spur import substitution and in services, but also certain domestic "value chains," citing cocoa as an example. Rojas cited PDVSA's ability to spend more quickly and efficiently than the GOV in general as their contribution to growth. Generally, GOV officials emphasized that their development strategy - termed "endogenous growth" - is based on greater state involvement in the economy, import substitution, and reliance on domestic resources - ideas that were in vogue in the 1950s and 1960s, as freely admitted by Quiaro.

¶4. (C) Venezuelan Central Bank (BCV) directors Domingo Maza Zavala (noted for his independence and hence widely seen as a thorn in the GOV's side) and Bernardo Ferran, while recognizing the difficulties of dependence on oil revenues, were critical of GOV policy. They stressed that GOV policy is to spend oil revenue now rather than invest it to create conditions for growth, a problem shared by previous administrations. They noted that, though Venezuela has never suffered from hyperinflation, the current inflation rate is much higher than the 40-year average. They asserted that it would be much higher if not for BCV operations. Maza Zavala and Ferran praised the idea of the Macroeconomic Stabilization Fund (FEM - a separate account created in 1999 to save high oil revenues to spend when revenue is low), but criticized the GOV for spending what had been saved (NOTE: the balance peaked at over USD 7.1 billion in 2001, but is currently only USD 708 million), plus increasing debt

simultaneously. Finance's Ortega, however, thought the FEM

needed to be reformed, in part by setting the reference value (currently defined as the average of oil revenues for the last five calendar years) in real terms rather than nominal. A better guide, he said, would be determining the proper level of primary expenditure necessary for continued strong economic growth and saving anything above that.

PRIVATE SECTOR - WAITING IN VAIN

¶5. (C) Meanwhile, the private sector, after an extended period waiting to see if there would be a change in administration, is acknowledging that - fairly or not - Chavez is firmly in charge until at least 2006, and quite possibly more. There is consensus that GDP growth will exceed 12% for 2004 (which still will not be enough to return economic output to 2001 levels), and be around 5% in 2005. Efrain Velazquez, President of the National Economic Council, thinks growth will continue through 2006, as long as oil prices remain high. Inflation is dropping and could be even lower (but still above 10%) next year, and foreign exchange liquidations are at their highest since exchange controls were imposed in January 2003. (September liquidations were more than the 2002 average.) Alejandro Grisanti, economic advisor to Banco Santander, noted that public/private sector dialogue to promote growth has begun.

¶6. (C) However, behind the recognition of good news, there is still a call for the GOV to implement structural reform, and little hope that it will. Albis Munoz, President of business umbrella group FEDECAMARAS, opined that the public/private dialogue would be limited, as neither group trusted each other. She cited continued punitive behavior by the Venezuelan tax authority (SENIAT - see reftel) and exchange control administration (CADIVI) as examples that political retaliation would not end. She stated that both entities were using the list of those who signed in support of the presidential referendum as criteria for actions. Banesco (a major private bank) Vice President and Chief Economist Pedro Coa noted that, should investors lose confidence in short-term GOV/BCV bonds, the money supply could quickly double, with terrible inflationary results. He added that the BCV is indeed combating inflation through constant sterilization, but having to do so is putting its solvency at risk. since they are offering high interest bonds (currently over 11%, but some outstanding bonds have rates over 21%) to reduce liquidity. Grisanti opined that increased CADIVI liquidations, given the artificially low official exchange rate, were like subsidies for the import sector - "how can anyone compete with the price of imports from China?" - which will further undermine local investment.

MULTILATERALS - DON'T ROCK THE BOAT

¶7. (C) Multilateral development bank lending in Venezuela is currently below traditional levels, which local representatives attribute to efforts to avoid politically sensitive issues. The World Bank, for example, according to consultant Angel Cardenas, does not plan to move forward with a new loan to the Venezuelan Supreme Court, despite pleasure with the results of a similar project that was recently completed, but will seek projects only in areas of infrastructure and urban development. He also mentioned being "afraid (the GOV) would change the rules of the game" as another reason to avoid sensitive loans. The Inter-American Development Bank (IADB) and the Andean Development Corporation (CAF) also plan to focus on infrastructure projects. IADB rep Roman Mayorga and CAF Vice President Fidel Jaramillo both cited inefficiency in the public sector as limiting factors for greater disbursement. Cardenas added that the GOV thinks it is doing things right, and therefore does not want help from multilaterals. Such help would, of course, also require greater transparency.

COMMENT

¶8. (C) The stark disparity between public and private perspectives on the future of the Venezuelan economy underlines the uncertainty that the country faces. The GOV appears hell-bent on not just spending its oil boom as quickly as possible, but taking on new debt to ensure the highest possible growth in advance of the 2006 presidential elections, ignoring the fact that it will leave Venezuela extremely ill-equipped to deal with a fall in oil prices. The new "Bolivarian" economic model - which is still only loosely defined - will also do nothing to address the

uncompetitiveness of the non-oil sector. Instead, it reverses the trend during the 1990,s toward both privatization and decentralization, forces the private sector into a position of dependence on the government and gives the central government an increasing role in industry and commerce, with little concern for efficiency or waste. At a minimum, these mark a return to the failed policies of the 70,s and 80,s. This model seems certain to depress foreign investment and entrepreneurial activity (though we may see some new decisions to put money into deals which offer relatively rapid returns as recovery lasts). As the multilateral lenders have no leverage with which to influence the GOV toward policy reform, and high oil prices require no change, the GOV will continue to set the agenda. However, until it is clear which way it is pushing the Venezuelan economy, the conditions for private sector commitments will remain elusive. Judicial insecurity, uncertainty over GOV macro-economic management, and high inflation (by regional standards) all lead to a situation which reduces the probability of significant investment - foreign or domestic - and takes the initiative from the private sector. Without the job creation that those would bring, growth will last only as long as high oil prices can sustain the spending boom.

¶9. (U) Treasury representative Haarsager has reviewed this cable.
Brownfield

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